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No. 82-108

In the

Supreme Court of the United States

October Term, 1981

CLEN CORPORATION, et al.,
PETITIONERS,

v.

O.C. ASSOCIATES, et al.,
RESPONDENTS.

MEMORANDUM OF PAUL LAZZARO, TRUSTEE OF CONTINENTAL INVESTMENT CORPORATION, IN SUPPORT OF PETITION FOR CERTIORARI

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TABLE OF CONTENTS

	Page
Table of Authorities	i
Reasons for Granting the Writ	2
I. The Court of Appeals' Decision Is Contrary to Decisions of This Court, Conflicts With Decisions of the United States Court of Appeals for the Second Circuit, and Improperly Interferes With the Laws of the States	2
II. Notwithstanding the Repeal of the Bankruptcy Act, the Court of Appeals' Decision Will Have Substantial Impact on the Rights of Creditors and Stockholders	2
III. The Questions Presented by the Court of Appeals' Decision Will Continue to be Relevant Under the New Bankruptcy Code	4
IV. The Issues Presented Herein May be Addressed Summarily by This Court	5
Conclusion	6

TABLE OF AUTHORITIES

Cases

In re Oahu Cabinets, Ltd., 12 Bankr. 160, 163 (Bankr. D. Hawaii 1981)	5

Statutes

Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549:	
11 U.S.C. prec. §101 (Supp. II 1978)	2
11 U.S.C. §502(b)(2) (Supp. III 1979)	4
11 U.S.C. §726(a)(5) (Supp. III 1979)	5

Treatises

3 Collier on Bankruptcy ¶502.02 at 502-33 (15th ed. 1982)	4

In the
Supreme Court of the United States

OCTOBER TERM, 1981

No. 82-106

GLEN CORPORATION, et al.,
PETITIONERS,

v.

O.C. ASSOCIATES, et al.,
RESPONDENTS.

MEMORANDUM OF PAUL LAZZARO, TRUSTEE OF CONTINENTAL INVESTMENT CORPORATION, IN SUPPORT OF PETITION FOR CERTIORARI

Paul Lazzaro, the Trustee in Reorganization (the "Trustee") of Continental Investment Corporation ("CIC"),[1] respectfully submits this memorandum in support of the petition of Glen Corporation, Monte J. Wallace, Neil W. Wallace and the Minority Stockholders' Committee of Continental Investment Corporation (collectively, the "Stockholders") for a writ of

[1] The Trustee was a party to the proceedings below and submits this memorandum under Rule 19.6 of the Rules of the Supreme Court of the United States. Pursuant to the Trustee's plan of reorganization, all the outstanding common stock of CIC was sold to Liberty National Insurance Holding Company, and the stock of CIC's wholly-owned subsidiary, Con-Vest Energy Corporation, was then resold to the Trustee and distributed to CIC's former shareholders. Paul Lazzaro is also the Trustee in Reorganization of Continental Mortgage Investors, No. 76-593-S (D. Mass.).

certiorari to the United States Court of Appeals for the First Circuit to review that court's judgment of April 30, 1982, in *O.C. Associates* v. *Continental Investment Corp.*, No. 81-1743; *Debentureholders Protective Comm. of Continental Investment Corp.* v. *Continental Investment Corp.*, No. 81-1741; and *Bankers Trust Co., Indenture Trustee* v. *Continental Investment Corp.*, No. 81-1756.

Reasons for Granting the Writ

I. The Court Of Appeals' Decision Is Contrary To Decisions Of This Court, Conflicts With Decisions Of The United States Court Of Appeals For The Second Circuit, And Improperly Interferes With The Laws Of The States.

The Trustee concurs with the Stockholders that, for the reasons stated in the Petition For A Writ Of Certiorari, certiorari should be granted to review the judgment of the court of appeals.

II. Notwithstanding The Repeal Of The Bankruptcy Act, The Court Of Appeals' Decision Will Have A Substantial Impact On The Rights Of Creditors And Stockholders.

The Bankruptcy Act was repealed by the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549. However, Section 403 of the Reform Act, 11 U.S.C. prec. § 101 (Supp. II 1978), provides that proceedings pending at its effective date continue to be governed by the Bankruptcy Act. While the number of such cases can only decrease, the effect of the court of appeals' decision, should it be permitted to stand, on the rights of creditors and, in particular, on the rights of shareholders of even a dwindling number of debtors under-

going reorganization under the Bankruptcy Act will be substantial.

The application of the court of appeals' decision in the CIC proceeding means a significant reduction in the cash available for distribution to holders of CIC's common stock.[2] The results of the application of the court of appeals' decision in another Chapter X reorganization pending in the First Circuit, that of Continental Mortgage Investors, No. 76-593-S (D. Mass.) ("CMI"), will be devastating.

On July 15, 1982, the United States District Court for the District of Massachusetts (Skinner, J.) issued its Memorandum and Order on Revised Reorganization Plans in the Chapter X reorganization of CMI.[3] Therein, the district court held that the court of appeals' decision is binding in the CMI proceeding and requires that holders of CMI's notes and debentures receive interest on the principal amount of their claims at the "legal" rate of 8% provided in the court of appeals' decision, rather than the rates of 5% and 6¼% provided in their contracts.[4]

The reorganization value found for CMI by the district court is sufficient to permit shareholder participation in the estate if debentureholders' claims are limited to contract-rate interest. The increase in interest on principal to the "legal" rate, compounded by the allowance of interest on the increased interest,[5] results in complete exclusion of some 25,000

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[2] Distributions to stockholders would be reduced by approximately $7 million, from an initially-estimated distribution of approximately $46 million. *See* Court of Appeals' Joint Appendix at 430.

[3] This order is not officially reported and appears as Appendix A to this Memorandum.

[4] The district court imposed this result without finding that the contractual provisions for the payment of interest on principal were invalid. Indeed, no argument had been raised by any party to the CMI proceeding that these provisions were unenforceable under state law.

[5] The district court also applied the court of appeals' decision to require the payment of post-petition interest on post-petition (but not pre-petition) interest on principal.

shareholders. CMI shareholders will lose more than simply the dollar amount of this increase. The CMI Trustee's plan provided for distributions of common stock in the reorganized company to CMI's current shareholders, thereby providing to the current shareholders the potential for increased value if the reorganized company were to prosper or to achieve successful results in pending litigation.

III. The Questions Presented By The Court Of Appeals' Decision Will Continue To Be Relevant Under The New Bankruptcy Code.

While § 502(b)(2) of the Bankruptcy Code, 11 U.S.C. § 502(b)(2) (Supp. III 1979), provides that a claim for "unmatured interest" shall not be allowed, a leading commentator has suggested that this provision must be read as "one of policy and convenience rather than a statement of substantive law." 3 Collier on Bankruptcy ¶502.02 at 502-33 (15th ed. 1982).

> This is primarily a technical policy device to cope in the most convenient, equitable, and economical way with the debtor's insolvency...
>
> It is true that in some cases the estate is sufficient to care for interest accrued after the filing date and in this situation it would seem inappropriate to return to the debtor a surplus of his assets after accommodation of all claims without a distribution to the creditors of accrued interest to the date of payment by the trustee. In short, a caveat to the general rule announced by section 502(b)(2) is that a debtor should pay interest computed to the date of payment, a rule whose operation is merely suspended where a debtor is so hopelessly insolvent that his assets in no way can pay the total amount of a claim, *i.e.*, principal and interest prior to bankruptcy.

> The 1978 legislation continues the proposition that a debtor may be charged with interest until the creditor is paid in full where there are sufficient assets to accommodate creditors within the scheme of the statute concerning priorities and allowability of claims.

Id. at 502-32 to -33 (footnote omitted).

Support for Collier's proposition is found in Section 726(a)(5) of the Bankruptcy Code, 11 U.S.C. § 726(a)(5) (Supp. III 1979), which, in providing for the priorities in distribution upon the liquidation of a debtor, requires the payment of interest "at the legal rate from the date of the filing of the petition" before any surplus of liquidation proceeds is returned to the debtor. In addition, the general rule applicable to the proceedings under Chapter X of the Bankruptcy Act that creditors of a solvent debtor receive interest on their claims has also been found logically applicable to reorganization proceedings under Chapter 11 of the Bankruptcy Code. *In re Oahu Cabinets, Ltd.*, 12 Bankr. 160, 163 (Bankr. D. Hawaii 1981).

Thus, the difficulties posed by the court of appeals' decision, in particular its holding that a rule of federal bankruptcy law overrides applicable state law recognizing or invalidating contractual commitments for the payment of interest, will continue to affect proceedings under the bankruptcy statutes.

IV. The Issues Presented Herein May Be Addressed Summarily By This Court.

The questions presented in the Petition For A Writ Of Certiorari involve the application of established principles of law, well developed in the decisions of this Court and the various courts of appeals. The Trustee respectfully suggests that oral argument is unnecessary and that this matter is appropriate for summary disposition by the Court.

Conclusion

For the reasons stated above, as well as those set forth in the Petition For A Writ Of Certiorari, the Trustee in Reorganization of Continental Investment Corporation respectfully submits that certiorari should be granted to review the decision of the court of appeals.

Respectfully submitted,

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August 7, 1982

APPENDIX A

UNITED STATES DISTRICT COURT
DISTRICT OF MASSACHUSETTS

In Proceedings for the
Reorganization of a
Corporation
No. 76-593-S

In Re

CONTINENTAL MORTGAGE INVESTORS,
DEBTOR

MEMORANDUM AND ORDER ON REVISED REORGANIZATION PLANS

July 15, 1982

SKINNER, D.J.

Hearings on the approval of a reorganization plan for Continental Mortgage Investors ("CMI") commenced on October 5, 1981, and continued for seven hearing days through October 16, 1981.

Following the October plan hearings, the court on December 18, 1981, entered an order ("the Order") finding the reorganization value of CMI, finding two of the reorganization plans before it not "worthy of consideration", and denying its approval to the other two filed plans. Order at 3-4, 7, 10. The parties were invited to submit substitute plans and the court made certain suggestions for plan provisions. Order at 10-11.

Further plans were submitted by the reorganization Trustee and Debentureholders' Committee B and a plan was submitted by Spartan Manufacturing Corporation ("Spartan").

Continued hearings were held on the plans on April 5, 7, 22 and 23, 1982. Among the witnesses were experts in investment banking, Tr. 3 to 62, 3-172 to 3-213, 3-214 to 3-238, 4-15 to

4-69, 4-154 to 4-156. The court also heard personal testimony from persons with a financial stake in the outcome of these proceedings. Tr. 4-73 to 4-145; Tr. 4-158 to 4-190.

Evidence was introduced to support the Trustee's plan and that of Spartan. Committee B presented no evidence in support of its own plans but stated that it might support the Spartan plan if Spartan could secure the necessary financing and if their investment bankers indicated that the Spartan plan were feasible. Tr. 21. On the last day of the hearing, Committee B stated that it was "still of an open mind" regarding the Spartan plan. Tr. 4-71.

The reorganization and liquidation values of CMI were determined in my Order of December 18, 1981. Clearly such valuations fluctuate with market conditions, but in a continuing proceeding, considerations of time forbid a rehearing on valuation at each step. I assume the valuations of December, 1981, to be still valid within a reasonable range of error, despite the current depression in real estate sales. Sales on Hawaii Loa Ridge ("the Ridge") have continued through the spring of 1982, though at less than the projected rate.

Committee B's Plan

Committee B's substitute plan bears a superficial resemblance to my suggestion contained in the Order.[1] Debentureholders are afforded an option of taking cash in the amount of 105% of the amount of their principal claims or stock in a reorganized CMI. The "New Trustees" of the reorganized company, however, would then be obliged to effect a sale of the entire Ridge as soon as practicable. In effect, this plan effects liquidation, which Committee B has been promoting throughout most of this case. The prospect of the proposed new corporation is for a short, bleak and un-

[1] There was expert testimony during the April hearing that my suggestion could not be effectuated in the present market without triggering a run on CMI's cash that would leave the resulting company unable to survive. I accept this testimony as being accurate and withdraw my suggestion.

profitable life. Any prudent debentureholder would take the cash options. Since 105% of the principal amount of the debentures far exceeds CMI's available cash, a distress sale of the Ridge would be required. For reasons stated in the Order, I do not consider this plan any more fair and equitable than Committee B's previous plan.

Spartan's Plan

The new entry is the plan offered by Spartan. Spartan's plan calls for the creation of a holding company of which each of Spartan Manufacturing Corporation and CMI is to be a subsidiary. Spartan Plan at 1. Distributions of securities under the plan are to be in securities of the holding company. *Id.* The plan provides that each creditor's claim will be satisfied by the issuance of stock and warrants and that a creditor may then choose to surrender the stock and warrants it receives for a pro-rata share of a $27 million cash fund plus, if surrendered securities exceed a certain level, a pro-rata share of 51% of the outstanding stock. *Id.* at 15-16. If surrendered securities stay below the threshold, each surrendering creditor will receive $1,050 cash in respect of each $1,000 principal of his claim (and nothing in respect of his interest claim, if any). *Id.* Shareholders' interests will be satisfied by the issuance of stock constituting 2% of the outstanding stock (if the debentureholder-surrender threshold is exceeded) or 4% thereof (if the threshold is not exceeded). *Id.* at 17.

Spartan's management refers to it as a "highly leveraged" company. In plain language, its assets exceed its debts by a very thin margin. Its 1981 debt/equity ratio was 8.4 to 1. Its debt service charges are currently $6 million a year. Over $50 million in debt is scheduled to mature before fiscal 1987. While its lines of credit have been renewed regularly up to now, failure of continuing renewal would put the company under. After payment of mandatory preferred stock dividends, Spartan shows no earnings applicable to common stock. The market price of its common stock has dropped from $3.50 per

share in October, 1981 to $1.25 per share in April, 1982. The aggregate market value of Spartan stock is only two-thirds of the value of the cash which CMI would bring to the venture. CMI security holders would own 55% of the combined corporation, but it would be managed by the Spartan board of directors, who enjoy an entrenched position under a Spartan by-law which would be carried over to the new company.

Spartan proposes to finance the cash pay-out to CMI debentureholders and provide for working capital as follows:

$7 million of CMI's cash,
$5 million of Spartan cash,
$30 million loan from a financial institution.

The entire plan is dependent upon securing the $30 million loan. The First National Bank of Boston has agreed to provide financing in the initial amount of $20 million on the following terms, *inter alia:*

(a) The first Hawaiian Bank must agree to a $10 million participation;
(b) The interest rate will be prime plus 2%;
(c) The bank will be paid an annual management fee of $200,000 regardless of the amount outstanding on the loan;
(d) The bank will share in the gross proceeds of lot sales, whether or not the loan has been repaid, in shares ranging up to 16% of gross sales proceeds and a maximum of $15,000,000, with a minimum annual payment of $500,000 even if no lots are sold;
(e) The loan will be secured by a first mortgage on Hawaii Loa Ridge and a pledge of all accounts receivable from lot sales;
(f) A bank-approved joint venture partner will be expected to contribute $500,000 and will receive 5% of gross sales. FNBB May Letter at 1-3.

The initial amount of the loan is a maximum of $20 million, with a "possibility of the loan rising to $30,000,000 depending on the valuation and availability of collateral".

Spartan believes that it is doubtful that either of the persons being considered as a joint venture partner would be willing to make a substantial cash investment in the venture. Tr. 3-78.

I find that the Spartan plan is neither fair nor equitable in that the outstanding debts of Spartan plus the proposed additional financing will leave CMI security holders with, in the most likely case, the prospect of another bankruptcy and, at best, the expectation of sharing in the hole after The First National Bank of Boston has eaten most of the doughnut. In fact, given the conditional nature of the bank's commitment, it is doubtful if the plan is even feasible.

Trustee's Plan

The Trustee's substitute plan is basically the same as its original plan, making an adjustment in stockholders' shares in the reorganized company to reflect the reorganization valuation contained in the Order.

My previous objection to the Trustee's plan, as stated in the Order, was the fact that investors were locked into a future investment of an uncertain nature without a financially viable escape. I was skeptical of Mr. Eisenberg's opinion that the reorganized company's build-up of assets would be reflected in the market price of stock.[2] That opinion has received persuasive inferential support in the new hearings in the testimony by Mr. Rosenthal, a speculator in "deep discount" bonds. ("We don't call it junk any more." T. 4-103, 104).

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[2] One additional new fact that emerged in the 1982 hearings was that all of the debentureholders who have been represented in this case bought their debentures at a small fraction of par. The most vociferous opponent of the Trustee's plan could recover his investment four or five times at the *present* market. While this has no legal significance, it does affect the weight I will give to his testimony.

It is unnecessary for me to decide if there will be sufficient protection in the marketplace for the shareholders in the reorganized company, however, since the Trustee's plan does not pass muster under a recent decision of our Court of Appeals. In *Debentureholders Protective Committee of C.I.C.* v. *C.I.C.*, __ F.2d __ (1st Cir., April 30, 1982), the Court held that in a case in pertinent respects on all fours with this one, the debentureholders are entitled to interest on unpaid post-petition interest as a matter of federal law. This is true even though the state law governing the rights of debentureholders (New York, in both cases) prohibits interest on interest. The state law was held to bar interest on pre-petition interest but not interest on post-petition interest. The court left open the question whether debentureholders could be required to accept a financially equivalent substitute, but held that mere acceleration of the time of payment was no more than the debentureholders were due under the terms of their debenture and was not a financially equivalent substitute in any case.

In addition to interest on post-petition interest, the *C.I.C.* opinion states flatly that interest on post-petition instalments of principal is to be allowed at the general legal rate of 8% rather than the contract rate. Presumably, it is still an open question as to whether a financially equivalent substitute may also be forced upon the debentureholders in lieu of this augmented interest. The Trustee argues that the rate of interest on instalments of principal was not at issue in *C.I.C.* (wherein he also served as Trustee) so that the Court's statement is *dictum*, and at variance with decisions in other circuits. I find the Court's conclusion surprising, but there it stands in black and white as a statement of the law of this Circuit, *dictum* or not, and I cannot ignore it. There may indeed be some justice in giving the holders of defaulted notes at least as good interest as other general unsecured creditors.

The Trustee and Committee B calculate the results of these strictures somewhat differently. The difference is unimportant

because in either case the debentureholders will share the entire estate and the shareholders will be excluded, since the debentureholders' claims exceed the reorganization value of CMI.

In an effort to preserve something for the shareholders notwithstanding the foregoing, the Trustee and the debtor repeat in effect the arguments made in behalf of shareholders in the first hearing, which I discussed at some length in the Order. They now concentrate on the rights the shareholders gave up to effect the Compromise with Senior Creditors, which in turn they say has increased the debentureholders' participation in the estate. Thus, according to the argument, the shareholders gave up something which permitted the debentureholders to do better in the reorganization than they otherwise would have done, and accordingly the debentureholders have already received the financial equivalent of interest on interest and interest at 8%.

One of the reasons for the Compromise, however, was the uncertainty of various claims against the Senior Creditors. As to what would have been the reorganization value of all of the assets of CMI as they existed before the Compromise, one can only speculate. Even accepting the very doubtful proposition that a benefit received other than as part of the reorganization plan itself can be accounted the financially equivalent substitute for interest on interest, I am unable to quantify the benefits accruing to the debentureholders from the Compromise with sufficient certainty to say that there is in fact financial equivalence.

Counsel for the debtor and for the Trustee correctly point out that in refusing interest on interest in the Order I recognized equities in favor of the shareholders. I am persuaded that the circumstances of the Compromise, the participation therein of debtor's counsel and the reasonable expectations of all of the parties at that time created some equities in favor of shareholders. Under the *C.I.C.* opinion, however, perceived

but inchoate equities are of no account in the face of a flat rule of law: debentureholders are entitled to interest on post-petition interest or to a financially equivalent substitute.

The net result of all of this is that the Trustee's plan must be rejected as not fair and equitable because it provides for shareholder participation without either allowing debentureholders their statutory 8% interest on post-petition instalments of principal and interest on post-petition interest or providing financially equivalent substitutes.

Accordingly, I shall further continue the plan hearing until September 20, 1982 to give the Trustee a chance to submit a further amended plan which conforms to the strictures imposed by the Court of Appeals in *C.I.C.*

So ordered.

(s) WALTER JAY SKINNER
United States District Judge